

Auditing Procedures Report

Issued under P.A. 2 of 1968, as amended.

Local Government Type <input type="checkbox"/> City <input type="checkbox"/> Township <input type="checkbox"/> Village <input checked="" type="checkbox"/> Other		Local Government Name Petoskey Hospital Finance Authority		County Emmet
Audit Date 6/30/05	Opinion Date 12/9/05	Date Accountant Report Submitted to State: 12/27/05		

We have audited the financial statements of this local unit of government and rendered an opinion on financial statements prepared in accordance with the Statements of the Governmental Accounting Standards Board (GASB) and the *Uniform Reporting Format for Financial Statements for Counties and Local Units of Government in Michigan* by the Michigan Department of Treasury.

We affirm that:

1. We have complied with the *Bulletin for the Audits of Local Units of Government in Michigan* as revised.
2. We are certified public accountants registered to practice in Michigan.

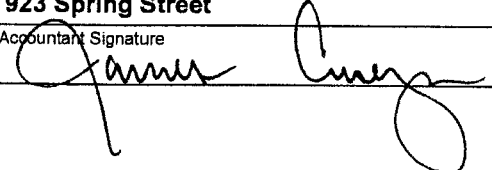
We further affirm the following. "Yes" responses have been disclosed in the financial statements, including the notes, or in the report of comments and recommendations

You must check the applicable box for each item below.

- | | |
|---|---|
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 1. Certain component units/funds/agencies of the local unit are excluded from the financial statements. |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 2. There are accumulated deficits in one or more of this unit's unreserved fund balances/retained earnings (P.A. 275 of 1980). |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 3. There are instances of non-compliance with the Uniform Accounting and Budgeting Act (P.A. 2 of 1968, as amended). |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 4. The local unit has violated the conditions of either an order issued under the Municipal Finance Act or its requirements, or an order issued under the Emergency Municipal Loan Act. |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 5. The local unit holds deposits/investments which do not comply with statutory requirements. (P.A. 20 of 1943, as amended [MCL 129.91], or P.A. 55 of 1982, as amended [MCL 38.1132]). |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 6. The local unit has been delinquent in distributing tax revenues that were collected for another taxing unit. |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 7. The local unit has violated the Constitutional requirement (Article 9, Section 24) to fund current year earned pension benefits (normal costs) in the current year. If the plan is more than 100% funded and the overfunding credits are more than the normal cost requirement, no contributions are due (paid during the year). |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 8. The local unit uses credit cards and has not adopted an applicable policy as required by P.A. 266 of 1995 (MCL 129.241). |
| <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No | 9. The local unit has not adopted an investment policy as required by P.A. 196 of 1997 (MCL 129.95). |

We have enclosed the following:

	Enclosed	To Be Forwarded	Not Required
The letter of comments and recommendations.			✓
Reports on individual federal financial assistance programs (program audits).			✓
Single Audit Reports (ASLGU).			✓

Certified Public Accountant (Firm Name) Hill, Schroderus & Co., LLP			
Street Address 923 Spring Street		City Petoskey	State MI
Accountant Signature 		ZIP Code 49770	Date 12/27/05

**FINANCIAL REPORT
PETOSKEY HOSPITAL FINANCE AUTHORITY
Year Ended June 30, 2005**

**PETOSKEY HOSPITAL FINANCE AUTHORITY
FINANCIAL REPORT
Year Ended June 30, 2005**

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Hill • Schroderus & Co., LLP

Certified Public Accountants & Consultants

December 9, 2005

Independent Auditors' Report

Board of Commissioners
Petoskey Hospital Finance Authority
Petoskey, Michigan

We have audited the accompanying financial statements of the Petoskey Hospital Finance Authority, Petoskey, Michigan, as of and for the year ended June 30, 2005, as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Petoskey Hospital Finance Authority, Petoskey, Michigan, as of June 30, 2005, and the changes in financial position and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Hill Schroderus & Co.

CERTIFIED PUBLIC ACCOUNTANTS
Petoskey, Michigan

Management's Discussion and Analysis

Overview of the Basic Financial Statements

The Petoskey Hospital Finance Authority's (the Authority) basic financial statements include a Statement of Net Assets, Statement of Revenues, Expenses and Changes in Net Assets and a Statement of Cash Flows. These are all reported using the accrual basis of accounting.

Financial Statements

The Statement of Net Assets presents the Authority's assets and liabilities, with the difference reported as *net assets*.

The Statement of Revenues, Expenses and Changes in Net Assets presents information showing how the Authority's net assets changed during the most recent fiscal year.

The Statement of Cash Flows presents cash flows from operations, financing and investing activities. Non-cash transactions that have an effect on the Authority's financial position are also presented.

Notes to the Financial Statements

The notes provide additional information which is essential to a full understanding of the data provided in the financial statements.

Financial Analysis

The table below summarizes the Authority's net assets as of June 30, 2005 and June 30, 2004:

PETOSKEY HOSPITAL FINANCE AUTHORITY		
	6/30/2005	6/30/2004
Assets		
Current	\$ 1,036,481	\$ 1,020,300
Other	41,035,707	41,947,791
Total assets	42,072,188	42,968,091
Liabilities		
Current portion of bonds payable	1,036,169	1,020,000
Bonds payable net of current portion, etc.	41,035,707	41,947,791
Total liabilities	42,071,876	42,967,791
Net Assets		
Restricted for debt service	\$ 312	\$ 300

Consistent with the prior year, the Authority is reporting a small positive balance for net assets restricted for debt service at the end of the fiscal year.

The results for the Authority as a whole are reported in the Statement of Revenues, Expenses and Changes in Net Assets, which is summarized below:

PETOSKEY HOSPITAL FINANCE AUTHORITY

	Year Ended	
	<u>6/30/2005</u>	<u>6/30/2004</u>
Revenues	\$ 2,163,546	\$ 2,060,638
Expenses	<u>2,163,534</u>	<u>2,061,343</u>
Excess (deficiency) of revenues over expenses	12	(705)
Net assets-beginning of year	<u>300</u>	<u>1,005</u>
Net assets-end of year	<u>\$ 312</u>	<u>\$ 300</u>

As shown above, the current year excess was \$12 while the prior year deficiency was \$705. The Authority relies on loan payments from the hospital to make the required bond payments. The Authority earns interest on these payments from the Hospital until the bond payments are actually made. The hospital is able to consider the interest retained by the Authority in determining its next required loan payment.

During fiscal 2004 bonds were issued in the amount of \$10,000,000 and a loan was made to the Hospital for a corresponding amount. There were no new bonds issued in fiscal 2005.

Economic Factors

The Petoskey Hospital Finance Authority was incorporated for the purpose of acquiring, constructing, remodeling, enlarging, repairing, owning and leasing health care facilities. It was also incorporated to finance or refinance these activities and to lend money to a hospital for similar purposes. Currently, the Authority has two loans outstanding with Northern Michigan Hospital related to the Series 1998 and 2003 Bonds as explained in the notes to the financial statements. The hospital has been making its loan payments on a timely basis. The expectation is that these timely payments will continue to be made and the related bonds will be retired as intended.

PETOSKEY HOSPITAL FINANCE AUTHORITY
STATEMENT OF NET ASSETS
June 30, 2005

Assets

Current assets:

Cash - restricted for Sinking Fund use	\$ 312
Current portion of loan receivable from Northern Michigan Hospital, Inc. (Hospital)	1,036,169
	<hr/>

Total current assets	1,036,481
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Loan receivable from Hospital

(net of current portion and unearned discounts and charges)	40,434,183
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Deferred charges - debt issue costs	601,524
	<hr/>

Total assets	\$ 42,072,188
	<hr/> <hr/>

Liabilities and Net Assets

Liabilities:

Current portion of bonds payable	\$ 1,036,169
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Bonds payable (net of current portion, unamortized original issue discount and unamortized refunding deferral)	41,035,707
	<hr/>

Total liabilities	42,071,876
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Net assets restricted for debt service	312
	<hr/>

Total liabilities and net assets	\$ 42,072,188
	<hr/> <hr/>

PETOSKEY HOSPITAL FINANCE AUTHORITY
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
Year Ended June 30, 2005

Revenues:	
Interest income	\$ 313
Payments received from Hospital to defray Series 1998 Bond interest expense	1,706,319
Payments made by Hospital to defray Series 2003 Bond interest expense	277,625
Payments made by Northern Michigan Hospital, Inc. for audit fees	2,800
Recognition of deferred revenue as revenue for current amortization of bond original issue discount, bond issue costs and refunding deferral, adjusting amounts actually due from Hospital to defray interest expense	176,489
Total revenues	<u>2,163,546</u>
Expenses:	
Interest expense	2,160,734
Audit fees	2,800
Total expenses	<u>2,163,534</u>
Excess (deficiency) of revenues over expenses	12
Net assets, beginning	<u>300</u>
Net assets, ending	<u><u>\$ 312</u></u>

PETOSKEY HOSPITAL FINANCE AUTHORITY
STATEMENT OF CASH FLOWS
Year Ended June 30, 2005

Cash flows from operating activities:		
Cash received from Hospital		<u>\$ 2,726,319</u>
Cash flows from capital financing activities:		
Principal paid on bonds		(1,020,000)
Interest paid on bonds		<u>(1,706,620)</u>
Net cash provided (used) for capital financing activities		<u>(2,726,620)</u>
Cash flows from investing activities:		
Sale of investments		2,727,210
Purchase of investments		<u>(2,726,910)</u>
Investment income		<u>313</u>
Net cash provided by investing activities		<u>613</u>
Net increase (decrease) in cash and cash equivalents		312
Cash and cash equivalents, beginning		<u>-</u>
Cash and cash equivalents, ending		<u><u>\$ 312</u></u>
Reconciliation of excess (deficiency) of revenues over expenses to net cash provided by operating activities:		
Excess (deficiency) of revenues over expenses		\$ 12
Adjustments to reconcile excess (deficiency) of revenues over expenses to net cash provided by operating income:		
Interest income	\$ (313)	
Amortization of deferred revenue	(176,489)	
Interest expense	2,160,734	
Non-cash operating revenue (expenses)	(277,625)	
Payments received for non-operating purposes	<u>1,020,000</u>	
Total adjustments		<u>2,726,307</u>
Net cash provided by operating activities		<u><u>\$ 2,726,319</u></u>

PETOSKEY HOSPITAL FINANCE AUTHORITY
NOTES TO FINANCIAL STATEMENTS
June 30, 2005

The Petoskey Hospital Finance Authority (the Authority), a governmental finance authority, was created as a corporate instrumentality in 1977 by the City of Petoskey under the provisions of the Hospital Finance Authority Act, Act 38, Public Acts of Michigan, 1969, as amended. The Authority was incorporated for the purpose of acquiring, constructing, remodeling, enlarging, repairing, owning and leasing health care facilities. It was also incorporated to finance or refinance these activities and to lend money to a hospital for similar purposes.

In prior years, the Authority constructed a new hospital facility and renovated existing hospitals for Northern Michigan Hospital, Inc. of Petoskey, Michigan (the Hospital). The Authority issued bonds to finance those projects and then leased the facilities to the Hospital. During fiscal 1990, additional bonds were issued which permitted expansion and refinancing of the project. Under the refinancing, a portion of the prior bonds were retired and the balance defeased. The facilities were sold to Northern Michigan Hospital, Inc. and the Hospital agreed to repay the Authority for monies the Authority had expended on behalf of the Hospital and amounts loaned to the Hospital for additional expansion.

In December, 1995, the Authority issued a revenue bond for the purpose of making a loan to the Hospital to be used to acquire, construct, renovate and equip hospital facilities pursuant to a Hospital Loan Agreement between the Hospital and the Authority.

In February, 1998, the Authority issued limited obligation revenue and refunding bonds. The bonds were issued to provide funds to be loaned by the Authority to the Hospital to be used, together with other available funds to (i) advance refund the Authority's Hospital Revenue and Refunding Bonds, Series 1989, (ii) current refund the Authority's Hospital Revenue Bond Series 1995, (iii) pay a portion of the costs of the project commenced in 1995 to acquire, construct, renovate and equip hospital facilities pursuant to a loan agreement between the Hospital and Authority and (iv) pay the costs of issuing the Bonds.

In October, 2003, the Authority issued limited obligation revenue bonds. The bonds were issued for the purpose of funding a loan by the Authority to the Hospital for the purpose of financing all or a portion of the cost of acquiring, constructing and equipping certain hospital facilities located in the City of Petoskey, Michigan and the payment of necessary costs incidental thereto.

Assets of the Authority are held by JP Morgan as Trustee for the Authority and bondholders.

NOTE 1: ACCOUNTING POLICIES

The financial statements of the Authority have been prepared on the accrual basis of accounting except for the recognition of interest income and expense as explained below. The Governmental Accounting Standards Board (GASB) is the standard-setting body for governmental accounting and financial reporting. The Authority's reporting entity applies all relevant Governmental Accounting Standards Board (GASB) pronouncements. The proprietary fund applies Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements, in which case, GASB prevails. Pronouncements of the FASB issued after November 30, 1989 are not applied in the preparation of the financial statements of the proprietary fund in accordance with GASB Statement No. 20.

NOTES TO FINANCIAL STATEMENTS – CONTINUED

NOTE 1: ACCOUNTING POLICIES - CONTINUED

Accounting policies for specific items follow:

Investments which are in U.S. Treasury securities are represented by a book entry at the Federal Reserve in the name of JP Morgan. All investments are credited to the account of the Authority by the Bank.

Loan receivable is carried at face value net of unearned discounts and charges.

Unearned discounts and charges is the difference between the face value of the loan receivable from the Hospital and the related bonds payable net of unamortized debt issue costs, original issue discount and refunding deferral. As interest expense is recognized for amortization of these items so is a corresponding amount of revenue recognized for amounts not due from the Hospital to defray this interest expense.

Outstanding bonds not defeased are recorded as a liability.

Deferred charges – debt issue costs of \$849,674 and \$110,249 are being amortized as interest expense using the interest method over the life of the Series 1998 and 2004 bonds, respectively. Interest expense of \$52,405 was recognized in the current year; unamortized amounts at year-end amounted to \$601,524.

Original issue discounts of \$597,467 are being amortized as interest expense using the interest method over the life of the Series 1998 bonds. Interest expense of \$30,791 was recognized in the current year; unamortized amounts at year-end amounted to \$355,381.

Refunding deferral (the difference between the requisition price and the net carrying amount of the Series 1989 bonds advance refunded) of \$2,039,539 is being amortized as interest expense on a straight-line basis over the original remaining life of the 1989 Series bonds. Interest expense of \$93,294 was recognized during the year. The unamortized balance at year-end was \$1,352,742.

Interest income associated with the investments is recorded when received. Interest expense associated with the bonds is recorded when cash is disbursed. Accruing interest expense would be offset by accrued revenue from the Hospital resulting in essentially the same position and results of operations.

For purposes of the Statement of Cash Flows, cash is considered to be cash on hand and demand deposits.

NOTE 2: BONDS DEFEASED IN PRIOR YEARS

During fiscal 1990, the Authority defeased the 1977 Series A Bonds, by placing a portion of the proceeds from the sale of the Hospital Revenue and Refunding Bonds, Series 1989, into an irrevocable trust to provide for all future debt service payments on the old bonds. During fiscal 1998, the Authority defeased the Series 1989 Bonds in the same manner. Accordingly, the trust account assets and the liability for the defeased bonds are excluded from the Authority's financial statements. At June 30, 2005, outstanding 1977 Series A Bonds aggregating \$3,945,000 are considered defeased. The Series 1989 Bonds were called during fiscal year 2000, with no outstanding balance remaining.

NOTES TO FINANCIAL STATEMENTS – CONTINUED

NOTE 3: BONDS PAYABLE

Petoskey Hospital Finance Authority Limited Obligation Revenue and Refunding Bonds, Series 1998, stated interest at 4.25% to 5.50%. (The effective interest rate for fiscal 2005 was 5.49% after inclusion of current amortization of bond issue costs, original issue discount and refunding deferral.)

\$ 33,780,000

Petoskey Hospital Finance Authority Limited Obligation Revenue Bonds, Series 2003, interest at a variable rate of interest adjusted on the first day of each month equal to 67% of the sum of 2% and the LIBOR rate. (The effective interest rate for fiscal 2005 was 2.86% after inclusion of current amortization of bond issue costs.)

10,000,000

Total bonds payable

\$43,780,000

Annual debt service requirements for the bonds are as follows:

Year ending June 30	Principal	Interest	Total
2006	\$ 1,306,169	\$ 1,863,142	\$ 3,169,311
2007	1,531,653	1,803,803	3,335,456
2008	1,590,382	1,743,829	3,334,211
2009	1,654,295	1,674,904	3,329,199
2010	1,728,398	1,596,638	3,325,036
2011-2015	9,845,424	6,791,532	16,636,956
2016-2020	12,148,741	4,421,162	16,569,903
2021-2025	9,150,632	2,140,146	11,290,778
2026-2028	4,824,306	351,842	5,176,148
Totals	<u>\$ 43,780,000</u>	<u>\$ 22,386,998</u>	<u>\$ 66,166,998</u>

Series 1998 Bonds

Petoskey Hospital Finance Authority Limited Obligation Revenue and Refunding Bonds (Northern Michigan Hospitals Obligated Group) Series 1998 are serial and term bonds maturing in ascending amounts on November 15 of each year through 2012 and then on November 15, 2018 and November 15, 2027. Interest payments are due May 15 and November 15 each year until maturity.

Under terms of the Loan Agreement between the Authority and Northern Michigan Hospitals, Inc., the Hospital has agreed to pay to the Trustee at specified times amounts adequate to pay all debt service costs associated with the bond issue.

The Hospital has agreed to make such payments from its income available for debt service. Such income generally includes the excess of revenue, including investment income and gifts not restricted by donors, over expenses, excluding depreciation, amortization, interest expense and certain extraordinary items. In addition, the Hospital has agreed to maintain its tax exempt status, maintain a ratio of income available for debt service to the annual maximum debt service requirement of at least 1.5 to 1, and to maintain a "cushion ratio" of at least 2 to 1.

NOTES TO FINANCIAL STATEMENTS – CONTINUED

NOTE 3: BONDS PAYABLE – CONTINUED

The "cushion ratio" is determined as the sum of all unrestricted and unencumbered/unpledged cash and liquid investments whether classified as current or non-current assets (including board-designated funds, but excluding self-insurance funds) held by the Hospital for various purposes, divided by the maximum annual debt service on all outstanding indebtedness that is not secured by a fully funded Debt Service Reserve Fund.

At June 30, 2005, the Hospital was in compliance with these requirements.

The revenue bonds are not a general obligation of Petoskey Hospital Finance Authority. Further, they are not a debt of the City of Petoskey, Michigan, nor has the City pledged its faith and credit for payment of the bonds.

Bonds maturing through November 15, 2007 are not subject to early redemption except in extraordinary situations as defined in the agreement. Bonds maturing on or after November 15, 2008 are subject to early redemption on or after May 15, 2008 at the option of the Authority in whole or in part at any time at a premium descending from two percent of face value for any early redemptions made prior to May 15, 2010. Any early redemptions made on or after May 15, 2010 are to be at par. Accrued interest is due on any early redemption.

Bonds maturing on November 15, 2018 and November 15, 2027 are subject to mandatory redemption commencing November 15, 2013 and November 15, 2019 each year at specified amounts but without an early redemption premium. Annual redemptions ascend from \$1,570,000 on November 15, 2013 to \$2,105,000 on November 15, 2019 and then from \$1,135,000 on November 15, 2020 to \$1,600,000 on November 15, 2027.

An insurance policy is in force which unconditionally and irrevocably guarantees the full and complete payment required to be made by or on behalf of the Authority.

Series 2003 Bonds

Petoskey Hospital Finance Authority Limited Obligation Revenue Bonds (Northern Michigan Hospitals Obligated Group) Series 2003 are payable to Fifth Third Bank, the bondholder, together with interest, at a tax exempt interest rate, which is a variable rate of interest adjusted on the first day of each month equal to 67% of the sum of 2% and the LIBOR rate. Accrued interest is paid each month through November 5, 2005. Commencing November 5, 2005, the monthly payment amount will consist of principal and interest, sufficient to amortize the unpaid principal of the bonds over a 20-year amortization period.

Under terms of the Loan Agreement between the Authority and Northern Michigan Hospitals, Inc., the Hospital has agreed to authorize the bondholder to automatically debit the Hospitals account for loan repayments due.

The Hospital has agreed to maintain its tax exempt status, and maintain a ratio of total liabilities to fund balances that does not exceed 1.75 to 1.00. Additionally, the Hospital has agreed to maintain a cash flow coverage ratio of not less than 1.50 to 1.00. The cash flow coverage ratio is defined as the sum of net income, depreciation, amortization and interest expense during the period to the sum of all principal and interest payments with respect to indebtedness that are due and payable during the period.

NOTES TO FINANCIAL STATEMENTS – CONTINUED

NOTE 3: BONDS PAYABLE – CONTINUED

At June 30, 2005, the Hospital was in compliance with these requirements.

The bonds are not a general obligation of the Petoskey Hospital Finance Authority. Further, they are not a debt of the City of Petoskey, Michigan, nor has the City pledged its faith and credit for payment of the bonds.

The bonds are subject to optional prepayment, in whole or in part, and without penalty or premium on any interest payment date at par plus accrued interest.

The bonds are subject to optional prepayment, in whole or in part, and without penalty or premium on any interest payment date at par plus accrued interest.

Both Northern Michigan Hospital Foundation and Northern Michigan Regional Health System, Inc. have signed guaranty agreements with Fifth Third Bank for the issuance of these bonds.

NOTE 4: LOAN RECEIVABLE AND PAYMENTS TO DEFRAY BOND INTEREST EXPENSE

Payments required by the Hospital include both principal and interest. Only the portion of the payments attributed to principal is applied against the loan receivable. The portion of the payments attributed to interest is recorded as a payment to defray interest expense.

Payments for the Series 1998 bonds by the Hospital are due on or about May 1 each year for the interest payment due May 15 on the Bonds, with credit on the payment for any amount on deposit. Further, payments are due on or about November 1 each year for the principal and interest payment due November 15 on the Bonds, with credit on the November 1 payment for any amount on deposit.

Payments for the Series 2003 bonds by the Hospital are due monthly. They are paid directly by the Hospital to the bondholder, Fifth Third Bank.

The Hospital has also agreed to pay all Trustee fees and all costs incurred by the Authority.